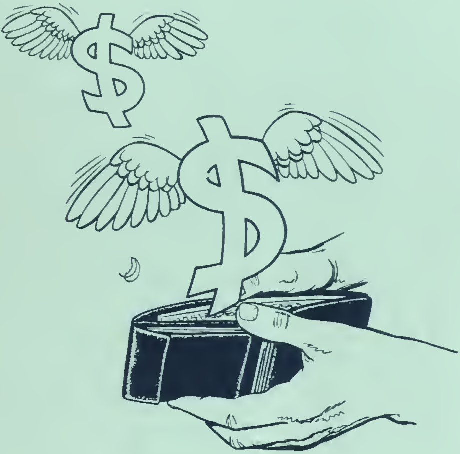
United States
Department of
Agriculture

Forest Service
Southeastern Area

Many Forest Landowners Pay Too Much Income Tax:



DO YOU?

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U.S. Department of Agriculture • Forest Service
Southeastern Area, State and Private Forestry
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Atlanta, Georgia 30367

in cooperation with

Southern State Foresters and Southern Extension Foresters

WHAT INCOME IS TAXABLE?

In the first place, probably only 40 percent of your net timber income is taxable. If you're like most forest landowners in America, your net income from the sale of standing timber can be treated as long-term capital gains—if you have owned the property at least 12 months and meet certain other requirements. But remember, the time to think about your income tax is before—not after—you sell your timber.

To be eligible for capital gains benefits, you must qualify under one of the following three categories. If you qualify for more than one category, find out which one best fits your situation. This is a key factor in receiving capital gains benefits.

1. **Lump-sum Sale.** This is for landowners who are not in the timber business and who sell their standing timber on a lump-sum basis. In other words, you sell standing timber outright for a fixed sum, agreed upon in advance. But remember, you don't have to own a sawmill or other manufacturing concern to be classified as being "in the timber business." Many times the deciding factor is how often you make a sale! You should check very carefully before you sell your timber on a lump-sum basis because of the danger of losing capital gains tax benefits.

2. **Sell as Cut.** This is for landowners who sell their timber under a cutting contract, whereby the timber is sold at the time it is cut. Under this arrangement, timber is sold on a unit basis (board feet or cord, for example), and payment is made only for those units actually cut. Be careful about this! The cutting agreement has to be worded correctly to qualify the income for capital gains treatment. See a tax expert. The advantage of this category is that you can be classified "in the timber business" and still qualify for capital gains benefits.

3. **Use in Own Trade or Business.** Landowners who cut their own standing timber and sell sawlogs, poles or pulpwood as a part of their trade or business can claim capital gains benefits under this category. This is also for landowners who cut their own timber and use it *in* their trade or business (a sawmill owner, for example). In either case, though, *owners must cut their own timber.*

Examples:

You are about to sell timber that was established 30 years ago and feel it would be easier to make a

lump-sum sale. You have made only two thinning sales in the past, so you may consider selling your timber on a lump-sum sale and file under Number 1, as shown on the previous page.

If you have made timber sales on a frequent and regular basis in the past and are ready to make another one, sell your timber on a ''sell as cut'' basis. This way, you will be assured of capital gains treatment if you follow the necessary steps mentioned previously under Number 2.

If you cut your own standing timber and sell logs or some other product, you would file under Number 3, on the previous page.

EXPENSES OF SALE

Remember, the amount you receive from the timber sale may not be your net income. It's not all clear profit if you have certain types of costs or expenses. You can deduct ''expenses of sale'' such as:

- tree marking expense
- scaling costs
- cruising costs
- consulting fees
- temporary road construction and improvements connected with the sale with a useful life of one year or less.

CAPITAL EXPENSES

You can recover ''capital expenditures.'' These costs are capitalized and recovered as the timber is harvested. Examples are:

- Purchase price of timber, including survey and legal fees. But don't forget, you have to determine the value of the land at the time of purchase and subtract that amount to know the purchase price of the timber.
- Site preparation, including removal of existing vegetation.
- Tree planting, including wages, tools and equipment.

OPERATING EXPENSES

You can deduct ''operating expenses'' incurred each year, such as:

- Cost of tools of short life or small cost
- Equipment maintenance costs
- Salaries, wages and professional fees (excluding your own time)

- Interest on mortgage payments connected with the timber.
- Certain taxes connected with the timber
- Depreciation allowance for equipment.

REFORESTATION TAX INCENTIVES

On October 14, 1980, Public Law 96-451 was enacted which includes new reforestation tax incentives. The reforestation incentive is a 10-percent, investment tax credit plus a 7-year amortization on the first $10,000 of capitalized reforestation expenditures each year. The incentive applies to qualifying reforestation expenditures incurred after December 31, 1979. **Therefore, capital expenditures for reforestation after 1979 that qualify under Public Law 96-451 can be recovered over a period of 7 years instead of when the timber is harvested, as described earlier in this folder.**

CASUALTY LOSSES

What does the Internal Revenue Service consider as a casualty loss? A casualty is the complete or partial destruction of property resulting from an identifiable event of a sudden, unexpected or unusual nature. Ice storms and hurricanes cause casualties. So do forest fires, sleet storms, hail, and floods. Death of trees from insect or disease attacks may not result in a casualty loss on business property, but death of trees on residential property usually qualifies. However, you should check with the Internal Revenue Service or a tax expert on possible new developments on casualty losses before filling out your tax return.

Tax laws on timber casualty losses become more understandable if you remember one important principle: to deduct a casualty loss, proof of a casualty—flood, hurricane, etc.—is necessary as well as proof that your loss occurred directly as a result of the casualty. Take photos and save newspaper clippings as proof of the casualty. Keep sales receipts, contracts, appraisal documents, or other verification of your property's value.

Casualty loss deductions are limited to the owner's adjusted basis in the timber. This is the total capital investment minus those capital expenditures previously recovered through either timber sales or other casualty deduction. Worth of the timber on today's market has nothing to do with the casualty loss for income tax purposes (except where the fair market value is less than the owner's cost). For example, suppose your entire timber stand, worth $100,000 on today's market, is destroyed. The

unrecovered capital investment in the timber, say, is $50,000, counting tree planting costs and other capital expenditures over the years. The deductible casualty loss would be limited to $50,000. If you lose only part of your timber compute the loss as follows:

1. First, divide your adjusted basis on the timber by the number of board feet or other units of timber in the tract. This gives the adjusted cost per timber unit. The Internal Revenue Service calls this the depletion unit. In the case of young plantations, acres can be used instead of board feet or cords.
2. Multiply this figure by the volume of timber or number of acres destroyed. This is the deductible loss.

Of course, if the insurance or salvage value received by the owner is equal to the amount lost, then the owner has no loss, for tax purposes.

Revenue Ruling 80-175

On July 7, 1980, the Internal Revenue Service ruled that if timber downed in a hurricane is salvaged and sold, the tax on the gain will be deferred if the proceeds are reinvested in reforestation on the same land or on qualified replacement property. The ruling specifically covered earthquakes and volcanic losses, but logically would encompass all casualties. Replacement property would likely consist of standing timber, bare timberland, timberland and timber, reforestation costs on land owned before the casualty, or reforestation costs on land purchased after the casualty.

Summary

In summary, be prepared to show proof on five points:

1. Nature of casualty and when it occurred.
2. The loss was the direct result of the casualty.
3. Ownership of the timber.
4. Cost of the timber and other expenditures.
5. Amount of insurance or salvage income received or recoverable.

RECORD KEEPING

Capital gains and tax deductions point up the value of record keeping to the timber owner. Bookkeeping needn't be complicated. All that's needed is an orderly listing of original costs and expenditures as they are made, backed up by appropriate receipts.

Examples:

1. Cost of timber to you—purchase price of property

less cost of land and improvements. Volume at time of purchase.

2. Establishment costs—site preparation and tree planting.
3. Cost of management services such as consulting fees.
4. Cultural practices which improve the quality of your timber stand.
5. Timber sales receipts.
6. Up-to-date volume (Periodically adjust for growth.)

If you feel you qualify for any of the benefits discussed here, you should seek additional information. Some sources are:

Your State forestry agency

Consulting forester

Qualified tax consultant

Extension forestry departments of your land-grant university

Local or district offices of the Internal Revenue Service.

COST-SHARE PAYMENTS

Cost sharing payments are available from the Federal Government through the Agricultural Conservation Program (ACP) and the Forestry Incentives Program (FIP) for such practices as site preparation and tree planting and timber stand improvements. The Revenue Act of 1978 and the Technical Corrective Act of 1979 provided that cost-sharing payments associated with capitalized reforestation expenditures would be considered tax-free income. If the cost-share payment is related to timber stand management expenses, the payment must be included in gross income. However, because a deduction may be allowed for such expenses, the net effect may be identical to the exclusion from gross income applicable to reforestation expenses.

The tax-free income provision of the Revenue Act of 1978 applies to those cost-share payments which are determined by the Secretary of the Treasury as not increasing substantially the annual income derived from the property. As of this writing, the Treasury Department has not ruled on whether FIP or ACP payments substantially increase the annual income derived from the property. Until the ruling is provided, the Technical Corrective Act of 1979 allows you to treat cost-sharing payments for reforestation expenses as tax-free income. Check with a tax expert for the latest developments.

Important: If you have failed to claim any of the benefits or deductions explained in this folder during the past 3 years, you still have time, in many cases, to file an amended tax form and seek reimbursement.

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